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No. 06-43

In the Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,
Petitioner,

v.

SCIENTIFIC-ATLANTA, INC., et al.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF OHIO, TEXAS AND *30* OTHER STATES AND COMMONWEALTHS AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

Whether shareholders can recover damages from actors who, acting with the requisite intent to deceive, actively engage in conduct that has the principal purpose and effect of creating a false appearance of fact in furtherance of a scheme to defraud the securities market, even when the actor has made no false statement or omission and otherwise owes no fiduciary duty to the shareholders.

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INTRODUCTION

This case has been described as "probably the most important legal issue for the securities industry in a generation."[1] The Court's decision here will profoundly affect not only the market as a whole, but investors large and small, and the faith that those investors will have in the market for years to come. The amici States urge the Court to support a healthy securities market, and the investors who rely on it, by overruling the Eighth Circuit below.

Our nation's system of monitoring fraud and eliminating it from the securities market relies on two fundamental presumptions: (1) wrongdoers disrupting the market should be held accountable for their bad acts and (2) those wronged should be compensated for their losses.[2] Violators of the securities laws therefore face the prospect of both criminal and civil liability for their conduct, with cases being prosecuted by state and federal securities regulators as well as by individual and class plaintiffs acting as "private attorneys general." Over time, this system has promoted market integrity, bolstered investor confidence, and made American markets what they are today: the global leaders "set[ting] the standard for the rest of the world."[3] This case poses the question whether the law will continue to protect the markets by providing a remedy for the wrongs suffered as the result of fraudulent corporate schemes under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C.

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[1] Christopher S. Rugaber, *Court to consider 'scheme liability' in Stoneridge suit against Motorola, Scientific-Atlanta*, Associated Press (Mar. 26, 2007) (quoting Robert Giuffra, attorney at law firm Sullivan & Cromwell).

[2] Keith L. Johnson, *Deterrence of Corporate Fraud Through Securities Litigation: The Role of Institutional Investors*, 60 Law & Contemp. Probs. 155 (Autumn 1997).

[3] Christopher Cox, Chairman, Sec. Exch. Comm'n, Remarks to the U.S. Chamber of Commerce's First Annual Capital Markets Summit: Securing America's Competitiveness (Mar. 14, 2007).

§78(j)(b), and SEC Rule 10b-5, 17 C.F.R. §240.10b-5. Investors (and other interested parties) here and abroad are anxiously awaiting the answer.

Petitioner Stoneridge Investment Partners, LLC ("Stoneridge") and Respondents Scientific-Atlanta, Inc. ("Scientific-Atlanta") and Motorola, Inc. ("Motorola") offer the Court two competing answers to the question. Stoneridge has argued that wrongdoers should be held liable for damages as primary violators under Rule 10b-5(a) and (c) where they participate in a "scheme or artifice to defraud" or by "engaging in a 'course of business which operates . . . as a fraud or deceit.'" *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.* (*In re Charter Commc'n, Inc. Sec. Litig.*) ("*Stoneridge*"), 443 F.3d 987, 991 (8th Cir. 2006). In Stoneridge's view, the defendant need not make misleading statements or omissions to be held liable; participating in a sham transaction with no legitimate business or economic purpose and with the requisite scienter should suffice. *Stoneridge*, Brief of Appellant Stoneridge, 2005 U.S. 8th Cir. Briefs Lexis 1974, at *22-31 (June 14, 2005).

On the other hand, Scientific-Atlanta and Motorola have argued that a defendant must make a misleading statement or omission to be held liable under Section 10(b) or Rule 10b-5 and, thus, scheme defendants who remain silent and owe no duty of candor to investors are categorically exempt. *Stoneridge*, Brief of Appellee Scientific-Atlanta, 2005 U.S. 8th Cir. Briefs Lexis 1974, at *10-13 (Aug. 15, 2005); *Stoneridge*, Brief of Appellee Motorola, Inc., 2005 U.S. 8th Cir. Briefs Lexis 1974, at *19-24 (Aug. 15, 2005).

The circuit courts considering the issue are split. The Ninth Circuit, in the *Homestore* case, articulated a test in line with Stoneridge's position, whereby participants in schemes with the "principal purpose and effect" of defrauding investors are held liable whether or not they made misleading

statements or omissions to investors. *Simpson v. AOL Time Warner, Inc.* (*In re Homestore.com, Inc. Sec. Litig.*) (*"Homestore"*), 452 F.3d 1040, 1048 (9th Cir. 2006). By contrast, the Eighth Circuit in *Stoneridge* and the Fifth Circuit in *Enron* have adopted Scientific-Atlanta and Motorola's narrow interpretation of scheme liability based on an erroneous interpretation of this Court's decision in *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994). See *Stoneridge*, 443 F.3d at 992; *Regents of the Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.* (*"Enron"*), 482 F.3d 372, 387 (5th Cir. 2007).

Amici States urge the Court to adopt our approach, which follows the Ninth Circuit's *Homestore* holding and, in this case, Stoneridge's position. This is the proper standard because the plain language of Section 10(b) and Rule 10b-5 reflects Congress's purpose that no defendant should be immune from scheme liability when that defendant possesses the requisite intent to deceive and actually engages in conduct that does in fact deceive investors. Indeed, our system of monitoring and eliminating securities fraud would be severely undermined if, as the Fifth Circuit recently ruled, the parties who "could have pulled the plug on Enron" get to walk away. *Enron*, 482 F.3d at 392. Neither the spirit nor the letter of the securities laws allows culpable individuals or companies actively participating in fraud schemes to escape liability for their actions. The amici States urge the Court to grant Stoneridge relief by reversing the Eighth Circuit's decision below.

INTEREST OF AMICI STATES

Amici States have an interest in the outcome of this appeal for several reasons. First, the States themselves are investors, representing some of the largest institutional investors in the world. In almost every case involving the scheme liability issue presented here, a state pension fund is

either lead plaintiff, opt-out plaintiff, or a class member with significant losses.[4]

Second, the amici States are uniquely sensitive to the plight of their small, individual investors. While the PSLRA has shifted the focus and responsibility for private securities fraud class actions to large institutional investors like state pension funds, it is often the small, individual investor who loses the most. For when the Enrons of the world go bankrupt, it is the States who come to these investors' aid as they face the day-to-day consequences of losing their jobs, homes, and life savings as a direct result of securities fraud.

Finally, amici States have a direct interest in the integrity and competitiveness of the securities markets from a public-protection standpoint. Fraudulent actors of all types must be deterred for the markets to function properly. The Court should reverse the decision of the Eighth Circuit to maintain this deterrence.

SUMMARY OF THE ARGUMENT

Amici States make three principal points. First, amici States demonstrate that culpable parties will be improperly shielded from liability if the Eighth Circuit is affirmed. This group includes the unprincipled accountants, lawyers, and banks, as well as unscrupulous vendors, who, even if they did not make misleading statements or omissions themselves, nonetheless intended to deceive and engage in sham

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[4] For example, in Ohio, two large state pension funds recently lost a motion to dismiss a defendant bank based primarily on the Eighth and Fifth Circuit scheme liability rulings at issue here. *In re Fannie Mae Sec. Litig.*, No. 04-1639, 2007 U.S. Dist. Lexis 33939, at *18-25 (D.D.C. May 8, 2007). Those same funds, plus two other Ohio funds, are also awaiting a ruling against defendant banks Merrill Lynch, Credit Suisse First Boston, and Barclays in a securities opt-out action, pending the related appeal to this Court of the Fifth Circuit's opinion in *Enron*. See *Pub. Empls. Ret. Sys. of Ohio v. Fastow (In re Enron Corp. Sec. Litig.)*, Case No. 02-CVH09-977, MDL-1446 (S.D. Tex. Mar. 20, 2007).

transactions. In the Enron frauds alone these "non-speaking" defendants made billions of dollars in ill-gained profits. Amici States oppose a rule that would allow defendants to escape liability and retain these profits. Significantly, the Court in *Central Bank* has already foreshadowed that these types of parties should be held liable under appropriate circumstances.

Second, amici States point out the other side of securities fraud cases: the victims. Amici States pay dearly in their own right as holders of large institutional pension funds in securities fraud schemes. But the most tragic cases are the individual investors who lose everything they own. These small investors need to recover at least some of the money they lose as a result of fraudulent schemes. All fraudulent actors, including those remaining silent, should contribute to these victims' recoveries.

Third, the amici States contend that "non-speaking" actors should be held liable for a primary violation of Section 10(b) where those actors, intending to deceive, actively participate in a "scheme to defraud" in which the principal purpose and effect of the scheme is to create a false appearance or statement of fact in furtherance of the scheme. It is not necessary for such actors to personally make the false statement or omission. This is the standard adopted by the Ninth Circuit in *Homestore*, and it is the standard that best accomplishes the dual purposes of the securities laws—to punish wrongdoers and compensate victims. Amici States accordingly urge the Court to overrule the conflicting Eighth and Fifth Circuit decisions.

ARGUMENT

A. Eliminating scheme liability for "non-speaking" actors will improperly exempt culpable banks, lawyers, accountants, vendors, and other non-issuing entities who all must be deterred for the securities regulation system to function properly.

The plain language of the securities laws—§ 10(b) and Rule 10b-5—expressly prohibits all deceptive devices and manipulative schemes involving the sales of securities. That is precisely the guarantee and protection that amici States advocate here. The Court need look no further than the facts of *Stoneridge*, *Homestore*, and, of course, *Enron* to see the reasons these protections should be maintained.

1. *Stoneridge*

In *Stoneridge*, two major cable equipment vendors (Scientific-Atlanta and Motorola) "accepted and returned" $20 payments from cable communications company Charter Communications, Inc., in exchange for free advertising to Charter's more than 6.4 million cable customers in 40 states.[5] See *Stoneridge*, 443 F.3d 987, 990 (8th Cir. 2006); *In re Charter Communications, Inc.*, 2004 U.S. Dist. Lexis 29647, at *15 (E.D. Mo. 2004). As these figures suggest, Charter was one of the largest cable-communications companies in the country and a lucrative source of business for both Scientific-Atlanta and Motorola.

According to the *Stoneridge* complaint, Scientific-Atlanta and Motorola worked directly with Charter in crafting the sham transactions and knew that Charter was using the "payments" to dupe investors into believing Charter was

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[5] See Charter Communications Holdings, LLC, Form 10-K for year ended December 31, 2000, at 4 (filed with Securities and Exchange Commission on April 2, 2001).

meeting the operating-cash-flow expectations of Wall Street analysts. In its opinion, the District Court for the Eastern District of Missouri noted several allegations indicating that "high level personnel" of both Scientific-Atlanta and Motorola were in fact "direct participants in the scheme":

- In August 2000, to cover a year-end operating-cash-flow shortfall of $15-$20 million, Charter's CEO and COO instructed John Pietri, Charter's Senior Vice-President of Engineering, to lobby Scientific-Atlanta and Motorola (the "vendors") to purchase time-slot advertising. The vendors had no interest.

- Pietri's superiors instructed him to approach the vendors again, this time with sham business transactions that would generate the appearance of operating-cash-flow growth for Charter. Charter offered to pay the vendors an additional $20 per set top box, provided the vendors would "return" the $20 payment to Charter. Charter would, in turn, give them free advertising. The vendors agreed. As a result, Charter's operating cash flow was inflated by $17 million and the vendors received their respective shares of $17 million worth of free cable advertising.

- Executives from both vendors worked directly with Pietri to fabricate documentation giving the transactions the appearance of valid arms-length business transactions.

In re Charter Communications, Inc., 2004 U.S. Dist. Lexis 29679, at *10-17 (E.D. Mo. 2004).

Assuming the allegations above are true, both Scientific-Atlanta and Motorola were active and knowing participants in the scheme to defraud and should be held equally liable for the harm the scheme caused Charter and its investors. In fact, the particularities of Charter's accounting scheme were sufficiently egregious to yield felony guilty pleas, probation

and prison time, and hefty fines for four of Charter's former executives.[6] Moreover, on the civil side, ten of Charter's key executives and Charter's independent auditor Arthur Anderson, LLP, paid a collective $144 million in cash and stock to settle class-action claims against them.[7] Scientific-Atlanta and Motorola, however, who both received millions in free advertising and millions more in equipment sales contracts, have incurred no criminal or civil penalties for their roles in the scheme. *Stoneridge*, 443 F.3d at 990.

The end result in *Stoneridge*, absent intervention by the Court, is that Scientific-Atlanta and Motorola retain their millions in ill-gotten gains, while Charter investors are unable to recover their millions in outstanding losses. Moreover, Scientific-Atlanta and Motorola can earn millions more in the next sham business transaction without penalty. Other cable equipment vendors also will be enticed to engage in these bogus but profitable transactions. Congress did not intend this result in passing the Securities Exchange Act of 1934; PSLRA, 15 U.S.C. §78u-4 *et seq.*, which expressly provides for proportionate and limited joint and several liability; or SLUSA, 15 U.S.C. §78bb(a).

2. Homestore

In *Homestore*, an Internet company engaged in more complicated "barter" or "round-trip" schemes with multiple companies to overstate its revenues by more than $170 million. *Homestore*, 452 F.3d at 1042. The other companies allegedly participating in the scheme were AOL Time Warner, Cendant Corporation, and L90.

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[6] Cheryl Wittenauer, *Charter Communications Executives Sentenced In Accounting Schemes*, The Detroit News, Apr. 23, 2005 www.detnews.com/2005/business/0504/23/biz-159359.htm; John Gibeaut, *An Outside Shot at Securities Fraud*, A.B.A. J. June 2007.

[7] *Id.*

According to the complaint, AOL was the first company to take fraudulent advertising commissions from Homestore. Homestore agreed to purchase shares in a thinly capitalized third party at an inflated price in exchange for that company's agreement to pass virtually all of that money to AOL in the form of "advertising fees." AOL, in turn, would share the advertising "revenue" with Homestore. The result was a fraudulent "triangular transaction" in which Homestore funneled money through the third party and AOL and back to itself as needed to meet analysts' revenue expectations.

Homestore's alleged scheme with Cendant was much simpler, though no less profitable. Homestore "grossly overpa[id]" Cendant $750 million for the purchase of the Web site Move.com, contingent on Cendant's promise to funnel some of the money back to Homestore. As with the money funneled through AOL, Homestore recorded the Cendant payment as "revenue" to meet analyst expectations. Cendant set up a separate corporate entity, Real Estate Technology Trust, which paid $95 million to Homestore for products and services following the Move.com sale. It is not clear how much of the remaining $655 million Cendant retained from the "sale" as its "commission."

L90's participation was similar to AOL's: funneling funds through a third party. Homestore's auditor became suspicious and required a confirmation letter from L90 before it would certify Homestore's 10-Q securities filing. L90 had already earned millions in fraudulent commissions before Homestore restated its financials.

As was the case with Charter, criminal and civil charges were quickly filed against Homestore and its executives. Eleven Homestore employees, including its former COO, CFO, and VP of Finance, were convicted of federal offenses in relation to the scheme. Homestore's CEO was convicted of conspiracy, insider trading, and falsifying corporate records

and SEC reports and received a 15-year prison sentence and $5 million fine for his part.[8] On the civil side, Homestore and several of its officers paid approximately $19 million in cash plus 20 million shares of stock in settlement while Homestore's auditor, PriceWaterhouseCooper, doled out an additional $17.5 million to Homestore investors.[9] AOL, Cendant, and L90, on the other hand, have not yet been held liable for their conduct. Following the Ninth Circuit's holding in *Homestore*—and unlike the "non-speaking" actors in *Stoneridge*—these entities *can* be held liable and compelled to pay their fair share, regardless of whether they personally made a false statement or omission.[10]

3. *Enron*

The well-known *Enron* case equally illustrates the reasons why the Eighth Circuit should be reversed. Numerous players were involved in the schemes that ultimately brought down the Houston corporate giant, among them nine of the largest banks and brokerage firms on Wall Street: J.P. Morgan Chase, Citigroup, Canadian Imperial Bank of Commerce ("CIBC"), Bank of America, Deutsche Bank, Lehman Brothers, Credit Suisse First Boston ("Credit

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[8] Press Release, U.S. Dep't of Justice, *Ex-CEO of Homestore.com Sentenced to 15 Years in Federal Prison for Orchestrating Scheme That Illegally Inflated Company's Revenue* (Oct. 12, 2006), http://losangeles.fbi.gov/dojpressrel/pressrel06/la101206usa.htm.

[9] Homestore.com, Inc. Class Action Settlement Information Website, "Q&A," http://www.homestoresettlement.com/questions.shtml (last visited June 11, 2007).

[10] To this point, the litigation in *Homestore* has not yet established whether AOL, Cendant, and L90's conduct, as a factual matter, constituted active participation in a deceptive scheme whose principal purpose and effect was to create a false statement of fact in furtherance of the scheme as the *Homestore* decision requires. 452 F.3d at 1054-55.

Suisse"), Merrill Lynch & Company, Inc. ("Merrill Lynch"), and Barclays Bank PLC ("Barclays").[11] Together, the banks and brokerages raised $6 billion for Enron through fraudulent debt and stock issues from 1996 through 2001 plus an additional $4 billion they channeled into Enron's sham partnerships Jedi, Chewco, LJM1 and LJM2.[12] The banks and brokerages themselves earned hundreds of millions individually—billions collectively—in commissions, consulting fees, and inflated interest. Moreover, select senior managers from the banks personally pocketed millions by investing their own money in Enron's "special entities" that promised returns of 1,000 percent or more.[13]

One of the Enron schemes relevant to this appeal is the "Nigerian Barges Transaction." According to the *Enron* complaint, Enron "sold" its interest in electricity-generating barges off the coast of Nigeria to Merrill Lynch with a side agreement to "buy back" that interest from Merrill Lynch six months later at a 20% premium. As was the case in *Stoneridge* and *Homestore*, the Enron plaintiffs allege that Merrill Lynch knew that Enron was using the sham transaction to inflate its revenues in its year-end financial statements.[14] 482 F.3d at 392. The Fifth Circuit held that

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[11] Press Release, University of California, *Banks, law firms, were pivotal in executing Enron securities fraud*, http://www.ucop.edu/news/enron/art408.htm (Apr. 8, 2002).

[12] *Id.*

[13] *Id.*

[14] There is evidence to support that allegation, which the Fifth Circuit specifically noted in its opinion. 482 F.3d at 377 n.1 (quoting e-mail between Merrill Lynch employees regarding the effect the Nigerian Barge transactions had on Enron's stock price and Enron executives' personal compensation). However, Plaintiffs will not get the opportunity to obtain additional evidence regarding Merrill Lynch's knowledge or alleged involvement in the scheme unless the Fifth Circuit is reversed.

Merrill Lynch owed no duty to Enron investors and is free of liability. *Id.*[15]

Although the Fifth Circuit lamented that Merrill Lynch and the other banks "do, after all, escape liability for alleged conduct that was hardly praiseworthy," the ultimate message the Fifth Circuit opinion sends to the banks who did not settle (and to Enron investors) is that there is no legal recourse for wrongs committed by "non-speaking" actors. *Id.*[16]

In sum, unless the court below is reversed, unscrupulous actors will keep the billions in ill-gotten gains and will continue to engage in profitable but illicit transactions. That is neither what Congress intended in the securities fraud laws nor what this Court intended in deciding *Central Bank*. Amici States urge the Court to reverse the Eighth Circuit's decision below.

B. Eliminating scheme liability for "non-speaking" actors will significantly diminish victims' right to compensation under the securities laws.

Enron's employees and retirees are probably the best-known victims of fraudulent securities practices. When the company collapsed, more than 4,000 Houston employees lost their jobs, and approximately 20,000 employees and retirees

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[15] On the criminal side, the Fifth Circuit also overturned the convictions of four former Merrill Lynch executives actively engaged in the Nigerian Barges Transaction. John C. Roper, *4 Ex-Merrill Lynch Execs' Convictions Overturned*, Houston Chron., Aug. 2, 2006, at A1.

[16] Credit Suisse had allegedly engaged in a similar sham transaction, known as "Osprey." 482 F.3d at 377 n.1 (quoting email between Credit Suisse employees acknowledging *"Osprey is a vehicle enabling Enron to raise disguised debt which appears as equity on Enron's balance sheet . . . ."* (emphasis added)).

lost $1.3 billion in their 401(k) accounts.[17] What is worse, the "employees most at risk were those who had expressed the most faith in Enron by putting their own contributions into Enron stock." Like most employees of large public companies, Enron employees had "the vast majority of their assets in Enron stock."[18]

Janice Farmer was one of those employees. "I was proud to invest in Enron stock," she said in testimony before a U.S. Senate committee. "We were a loyal and hardworking group of employees. We lived, ate, slept and breathed Enron because we were owners of the company. I trusted the management of Enron with my life savings."[19] Ms. Farmer lost $700,000. Charles Prestwood was another Enron employee. He saw his retirement nest egg dissolve almost instantaneously, from $1.3 million to $8,000:

> All Charles Prestwood wanted was to travel beyond Texas. All he wanted was an employer that wouldn't destroy his 401(k), a financial system to keep his employer honest, and, now, judges to hold that employer and those banks liable for the theft of his old age. "I cannot understand judges who would look at the people who designed the theft, provided the money to do it and drove the getaway car, and say that they didn't do anything. This country boy."

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[17] Damien Cave, *401 Reasons to Love Enron*, Salon, Jan. 17, 2002, http://air.salon.com/story/tech/feature/2002/01/17/401l/index.htm

[18] *Id.* Enron employees had invested 60% of their assets in company stock, which is not unusual. Procter & Gamble employees invest 94% of their assets in company stock, Sherwin-Williams employees invest 90% of their assets in company stock, and Coca-Cola employees invest 81% of their assets in company stock. *Id.*

[19] Quoted in Christopher Ketcham, *Enron's Human Toll*, Salon, Jan. 23, 2002, http://air.salon.com/story/tech/feature/2002/01/23/enron_to l /index .html.

he says, "has a hard time interpreting these things."[20]

The only way for victims such as Ms. Farmer and Mr. Prestwood to recover anything at all in catastrophic bankrupting frauds like Enron is for culpable "non-speaking" actors to be held liable. Virtually all of the record $7.1 billion settlement to investors in Enron came from "non-speaking" actors: CIBC, $2.4 billion; JP MorganChase, $2.2 billion; Citigroup, $2 billion; Lehman Brothers, $222.5 million; and Bank of America, $69 million.[21] Without those funds, many individual Enron shareholders would have received nothing; and without "scheme liability," many more defrauded investors will receive nothing. The amici States therefore urge the Court to reverse the Eighth Circuit and allow investors to recover from all culpable actors who actively engage in securities fraud schemes, regardless of whether they personally made a material misstatement or omission.

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[20] Harold Meyerson, *Enron's Enablers: The Finance Firms That 'Drove the Getaway Car'*, Wash. Post, May 9, 2007, at A17.

[21] Press Release, University of California, *UC and Enron Investors Join Coalition Urging the SEC to Protect Investors and Hold Banks Accountable For Securities Fraud*, http://www.universityofcalifornia.edu/news/2007/may09.html (May 9, 2007).

C. Liability for "non-speaking" actors in a securities fraud scheme should turn on the principal purpose and effect of those actors' own conduct and their culpability, not whether those actors personally made (or successfully avoided public attribution of) a false statement or omission.

1. The plain language of § 10(b) does not limit liability to actors making public statements or omissions.

The federal securities laws, on their face, hold *any* person liable for *any* manipulative or deceptive device or contrivance. The language does not make distinctions based on title, profession, or industry; does not immunize any category of persons or entities; and, importantly, does not limit liability to actors making public statements or omissions. The language of the principal anti-fraud provision of the federal securities laws is extremely broad. Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful, "directly or indirectly" for "any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or . . . contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe." Securities Exchange Act of 1934 § 10(b), 15 U.S.C. § 78(j)(b).[22]

In addition, the Court has held that §10(b) broadly prohibits the use of any "manipulative or deceptive device or contrivance" in connection with the purchase or sale of securities, including manipulation or deception as part of a

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[22] In defining liability for securities fraud under § 10(b), the Court must "turn first to the language of § 10(b), for 'the starting point in every case involving construction of a statute is the language itself.'" *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976) (*quoting Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 756 (1975)).

larger scheme to defraud the broader securities market. See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, at 199 (1976). In fact, in the context of a fiduciary relationship, the Court has already held that that a non-speaking actor who engages in a scheme to defraud has used or employed a deceptive device within the meaning of § 10(b). *SEC v. Zandford*, 535 U.S. 813, 821-22 (2002). Moreover, the Court has recognized that deception can be undertaken in a variety of ways other than through false statements or omissions. In *Ernst & Ernst*, the State Court stated that "device" broadly means "an invention; project; scheme; often, a scheme to deceive; a stratagem; an artifice," and that "contrivance" means any "thing contrived or used in contriving; a scheme, plan, or artifice." 425 U.S. at 199 n.20 (quoting Webster's International Dictionary (2nd ed. 1934)).

However, in its decision below, the Eighth Circuit categorically and improperly held that a "device or contrivance is not 'deceptive,' within the meaning of § 10(b), absent some misstatement or a failure to disclose by one who has a duty to disclose." *Stoneridge*, 443 F.3d at 992 (citing *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 474-75 (1977)). The Eighth Circuit's interpretation of § 10(b) is not supported by the statute's text. Neither § 10(b) nor related provisions make any reference to public statements or omissions, but instead broadly prohibit the use of *any* "manipulative or deceptive device or contrivance" connected to the securities market.

In determining that deceptive conduct must involve "either a misstatement or a failure to disclose by one who has a duty to disclose," the Eighth Circuit improperly relied on this Court's decision in *Santa Fe*. The *Santa Fe* Court decided issues related to breach of fiduciary duty under Rule 10b-5--not broader scheme liability under § 10(b). The primary holding of the *Santa Fe* decision was that "breach of fiduciary duty by majority stockholders, without any

deception, misrepresentation, or nondisclosure, [does not violate] the statute and the Rule." 430 U.S. at 475-76. Indeed the *Santa Fe* Court's separate references to deception, misrepresentation, and nondisclosure indicate that deceptive conduct may take forms other than statements or omissions: "Congress [in enacting § 10(b)] meant to prohibit the full range of ingenious devices that might be used to manipulate securities prices." *Id.* at 477. The Eighth Circuit's decision below cannot be squared with either the statute's text or this Court's clear statements regarding the breadth of § 10(b), and must be reversed.

Given the plain language of § 10(b) and the definitions set forth by the Court, and regardless of statements or omissions by the parties, amici States urge that conduct that has the core purpose and effect of creating a false impression in the securities realm can constitute a "manipulative or deceptive device or contrivance" under § 10(b). As articulated by the Ninth Circuit in *Homestore*, 452 F.3d at 1052, the plain language of § 10(b) necessitates "that conduct by a defendant that had the principal purpose and effect of creating a false appearance in deceptive transactions as part of a scheme to defraud is conduct that uses or employs a deceptive device within the meaning of § 10(b)."

2. The plain language of Rule 10b-5 does not limit liability to actors making public statements or omissions.

Section 10(b) expressly authorizes to the Securities and Exchange Commission to define "manipulative or deceptive devices or contrivances" through "such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. §78(j)(b). The SEC first exercised this authority in 1942 by adopting Rule 10b-5 to specify three overlapping yet

distinct categories of manipulative or deceptive devices or contrivances:

> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

17 C.F.R. §240.10b-5. Only subsection 10b-5(b) provides that the defendant make a deceptive misstatement or omission. In contrast, subsections 10b-5(a) and (c) curtail conduct and behavior, rather than statements. "To be sure, the second subparagraph of the rule specifies the making of an untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs are not so restricted." *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 152-53 (1972).

Thus, under the plain language of Rule 10b-5, a person or other entity may be held liable for any of the following:

1. Employing a device to defraud;[23]
2. Employing a scheme to defraud;[23]
3. Employing an artifice to defraud;[23]
4. Making any untrue statement of a material fact;[24]

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[23] 17 C.F.R. §240.10b-5(a).

[24] 17 C.F.R. §240.10b-5(b).

5. Omitting to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading;[24]

6. Engaging in an act which operates or would operate as a fraud or deceit upon anyone;[25]

7. Engaging in a practice which operates or would operate as a fraud or deceit upon anyone;[25] or

8. Engaging in a course of business which operates or would operate as a fraud or deceit upon anyone.[25]

Thus, the SEC rules themselves indicate that a statement or omission is not necessary to establish a primary violation of 10b-5.

Consistent with the inclusive language of both the statute and the Rule, the Court has repeatedly emphasized the extensive anti-fraud purposes of the federal securities laws. See, e.g., *Zandford*, 535 U.S. 813 (emphasizing broad language and interpretation of anti-fraud provisions and citing cases); *United States v. O'Hagan*, 521 U.S. 642, 658 (1997) (noting that Congress intended "to insure honest securities markets and thereby promote investor confidence"); *Affiliated Ute Citizens*, 406 U.S. at 151 (holding that proscriptions of § 10(b) and Rule 10b-5 "are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive").

The Court has noted that the 1934 Act and its companion legislative enactments embrace a "fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry." *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963).

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[25] 17 C.F.R. §240.10b-5(c).

"We do not think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities.'" *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (1971) (quoting *A. T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)). "Novel or atypical methods should not provide immunity from the securities laws." *Id.* Thus, § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, even if some of the actors involved did not make untrue statements or omit to make material statements.

3. *Central Bank* supports the proposition that actors using or employing a manipulative or deceptive device may be liable as primary violators of Section 10(b) or Rule 10b-5.

Liability for using or employing a manipulative or deceptive device is not barred by the Court's decision in *Central Bank*. In that case, the parties conceded that the defendant did not commit any act or practice under § 10(b). The *Central Bank* Court did not explore what constitutes a primary violation under the statute. See 511 U.S. at 191. Rather *Central Bank* held only that liability does not attach for merely aiding and abetting a primary violation.

The *Central Bank* Court expressly said that "[a]ny person or entity including a lawyer, accountant, or bank, . . . may be liable as a primary violator under Rule 10b-5." *Id.* "The absence of § 10(b) aiding and abetting liability does not mean that secondary actors in the securities markets are always free from liability under the securities Acts." *Id.* Even more to the point, *Central Bank* did not strike down any language in § 10(b) or Rule 10b-5 or sweep away the extremely broad anti-fraud purposes of the federal securities laws.

The Court held in *Central Bank* only that, to be liable, a defendant must itself employ one or more of the eight types

of manipulative or deceptive devices or contrivances specified in Rule 10b-5, rather than merely assist another in doing so. In other words, *Central Bank* concerned the relationship or connection between the defendant and the fraudulent conduct; it did not alter the definition of the fraudulent conduct itself. See *id.* at 167 (question before Court was "whether private civil liability under § 10(b) extends as well to those who do not engage in the manipulative or deceptive practice, but who aid and abet the violation"). *Central Bank* did not address or alter the basic concept that any person or entity may be liable as a primary violator of § 10(b) or Rule 10b-5.

Nonetheless, Respondents interpret *Central Bank* to allow an actor to escape liability for participation in a securities fraud as long as he is crafty enough to carefully avoid the public attribution to him of a false statement. Respondents' interpretation and expansion of *Central Bank* will result in virtual immunity from private liability for culpable banks, law firms, accountants, and other actors in many cases. And their interpretation directly conflicts with both the broad language and purposes of § 10(b) and Rule 10b-5.

Indeed, it is precisely with respect to such schemes that the anti-fraud provisions are needed the most. The amici States urge the Court to continue to hold liable those "behind the scenes" actors who participate in and benefit from fraudulent schemes but avoid making misleading statements or omissions.

4. "Non-speaking" actors are subject to primary liability so long as their own conduct contributing to the scheme has a deceptive purpose and effect.

Since *Central Bank*, the principal duty of the courts in scheme-liability cases has been to determine what constitutes a "primary violation" of § 10(b). In *Central Bank*, the Court

held that liability under § 10(b) attaches only to "primary violators" and that there can be no liability for merely "aiding and abetting" a violation. 511 U.S. at 191. The amici States urge the Court to set forth a test for such liability based on two important and discrete showings: first, the defendant must possess the requisite intent to deceive, i.e., the same level of scienter required of all primary violators; and second, the defendant must have actively participated in a scheme whose principal purpose and effect was to create a false appearance of fact in furtherance of that scheme.

a. Primary liability under Section 10(b) and Rule 10b-5 may attach to "non-speaking" actors for false statements and omissions, even if the actors did not personally make the statement or omission.

After *Central Bank*, the courts have taken two general approaches to scheme liability under § 10(b)—the "substantial participation" standard and the "bright line" standard. Some courts have held that "substantial participation . . . in the preparation of fraudulent statements is grounds for primary liability even though that participation might not lead to the actor's actual making of the [false] statements." *Howard v. Everex Sys., Inc.*, 228 F.3d 1057, 1061 n.5 (9th Cir. 2000); see also *In re Software Toolworks Inc. Sec. Litig.*, 50 F.3d 615, 628-29 (9th Cir. 1994). Under this "substantial participation" approach, to establish primary liability for a "non-speaking" actor it must be shown that: (1) the defendant either made a misrepresentation or omission, or "substantially participated" in the preparation of a misrepresentation made by someone else; and (2) the defendant knew or should have known that the misrepresentation or omission would be relied on by

investors, but public attribution of the "non-speaking" actor's role is unnecessary.[26]

Conversely, under the "bright line" approach, adopted by the Eighth Circuit below, to establish primary liability it must be shown that: (1) the defendant itself actually made a materially false or misleading statement (or omitted a material fact while under a duty to disclose); (2) the defendant knew or should have known that the misrepresentation or omission would be relied on by investors; and, at least according to a few courts, (3) the misstatement was attributed to the defendant at the time of its dissemination.

Neither test requires that the alleged violator actually directly communicate misrepresentations to the plaintiffs for primary liability to attach. See *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 964-72 (C.D. Cal. 1994) (employing "substantial participation" approach) ("[L]iability under Section 10(b)/Rule 10b-5 is not limited to the making of materially false and misleading statements or omissions . . . ."); *Wright v. Ernst & Young LLP*, 152 F.3d 169, 171-76 (2d Cir. 1998), cert. denied 525 U.S. 1104 (1999) (employing "bright line" approach) ("There is no requirement that the alleged violator directly communicate misrepresentations to plaintiffs for primary liability to attach.") (quoting *Anixter v. Home-Stake Prod. Co.*, 77 F.3d 1215, 1225-27 (10th Cir. 1996) (same)). Rather, the defendant need have only known or recklessly disregarded

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[26] Several federal district courts also have adopted this view. See, e.g., *Wenneman v. Brown*, 49 F. Supp. 2d 1283, 1287-91 (D. Utah 1999); *Adam v. Silicon Valley Bancshares*, 884 F. Supp. 1398, 1400 (N.D. Cal. 1995); *In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960, 971-72 (C.D. Cal. 1994); *Hill v. Hanover Energy, Inc.*, No. 91-1964 (JHG), 1991 U.S. Dist. Lexis 18566 (D.D.C. Dec. 16, 1991); *In re Union Carbide Corp. Consumer Prods. Bus. Sec. Litig.*, 676 F. Supp. 458, 467-70 (S.D.N.Y. 1987).

the fact that its misrepresentation or omission would be relied on by investors. See *McGann v. Ernst & Young*, 102 F.3d 390, 397 (9th Cir. 1996), *cert. denied* 520 U.S. 1181 (1997) (employing "substantial participation" approach); see also *McNamara v. Bre-X Minerals Ltd.*, No. 5:97-CV-159, 2001 U.S. Dist. Lexis 4571, at *131 (E.D. Tex. Mar. 30, 2001) (employing "substantial participation" approach). Thus, neither test requires that the alleged violator actually directly communicate misrepresentations to plaintiffs for primary liability to attach. Therefore, some significant role in the preparation or creation of a misstatement that is directly communicated to investors by another party can suffice for primary liability under either post-*Central Bank* test.

A few "bright line" courts have adopted—with no valid basis—the additional requirement that, whether the defendant's statement is communicated directly to investors or indirectly through others, the defendant's statement must be attributed to the defendant by name to be actionable. See *Ziemba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205-12 (11th Cir. 2001); *Wright*, 152 F.3d at 171-76. Courts that have adopted the attribution requirement have done so on the mistaken assumption that imposing liability on a defendant when the investors did not know of the defendant's involvement in the misrepresentation negates the requisite element of reliance. But that reasoning is flawed. Plaintiffs certainly can rely on a statement without knowing exactly who made it. And, reliance can exist even when the statement was not signed by the defendant or when the defendant was not identified by name.

Moreover, nothing in *Central Bank* mandates the conclusion that the concept of "making an untrue statement" is limited to signing such a statement or having such a statement identify its speaker by name. In fact, the Supreme Court recognized in *Central Bank* that liability requires reliance on a misrepresentation, not on a misrepresentation

that is identified as the statement of a particular person: "Any person or entity, including a lawyer, accountant, or bank, who . . . makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under Rule 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met." 511 U.S. at 191. If the word "indirectly" in § 10(b) and Rule 10b-5 means anything, it certainly should cover the situation where a defendant creates a misrepresentation but carefully avoids being publicly identified with it. Fraudulent misrepresentations should not be immune from liability just because their creator is concealed. Otherwise, every culpable "non-speaking" actor would easily avoid liability simply by conditioning its services on remaining anonymous in any public statements.

b. Primary liability may attach to a "non-speaking" actor for participation in a scheme to defraud if (1) the scheme had the principal purpose and effect of creating a false appearance of fact and (2) the actor's own conduct contributing to the scheme had a deceptive purpose and effect.

As explained above, § 10(b) specifically authorizes the SEC to set forth rules and other interpretive parameters of § 10(b)'s reach. Thus, where appropriate, courts should look to and give deference to the Commission's interpretation of § 10(b) as set forth in Rule 10b-5. See *Chevron, U.S.A., Inc. v. National Resources Defense Council, Inc.*, 467 U.S. 837, 843-44 (1984). Thus, the SEC's "interpretation of the ambiguous text of § 10(b), in the context of formal adjudication, is entitled to deference if it is reasonable." *Zandford*, 535 U.S. at 819-20.

Notably, in the SEC's amicus brief in *Homestore*, on which the federal district court relied in *Enron*, the SEC recognized two points critical to the analysis here. First, the

SEC noted that "where a wrongdoer, intending to deceive investors, engages in a deceptive act as part of a scheme to defraud, he can cause the same injury to investors, and the same deleterious effects on the market regardless of whether he designed the scheme." *Newby v. Enron Corp.*, No. H-01-3624 2006 U.S. Dist. Lexis 43146 at *164-65 (S.D. Tex. June 5, 2006). And second, the SEC stated that the "deceptive acts under Section 10(b) include conduct beyond the making of false statements or misleading omissions, for facts effectively can be misrepresented by action as well as by words." *Id.*

In its amicus brief, the SEC further elaborated that "a 'deceptive act' includes a transaction whose principal purpose and effect is to create a false appearance of revenue which can be accomplished by acts as well as by words." *Id.* at *167. The Ninth Circuit in *Homestore* agreed with the SEC's position that "[a]ny person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator." 452 F.3d at 1048.

In contrast, the court below adopted a new version of the "bright line" test as to scheme liability, whereby "any defendant who does not make or affirmatively cause to be made a fraudulent misstatement or omission, or who does not directly engage in manipulative securities trading practices, is at most guilty of aiding and abetting and cannot be held liable under § 10(b) or any subpart of Rule 10(b)-5." *Stoneridge*, 443 F.3d at 992. But this standard is not supported by either the text of, or the SEC's interpretation of, the statute and rule.

The amici States agree with the Ninth Circuit's interpretation of § 10-b and Rule 10b-5 as reflected in the *Homestore* opinion. Under that standard, "non-speaking" actors like Scientific-Atlanta, Motorola, AOL, Cendant, and

L90 will be held liable when they actively participate in schemes with both the principal purpose and effect of defrauding investors. Unlike the standard adopted by the Fifth and Eighth Circuits, which allows culpable banks, lawyers, accountants and others to escape liabil ty for fraudulent transactions, the Ninth Circuit standard supported here will deter individuals and companies from engaging in fraudulent activities when similar opportunities to defraud investors arise in the future.

CONCLUSION

For the above reasons, amici States ask the Court to reverse the Eighth Circuit's decision below.

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